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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

No. 282

UNITED STATES OF AMERICA,
Petitioner,

vs.

MACLIN P. DAVIS and EDITH U. DAVIS,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

~~REPLY~~ BRIEF FOR MACLIN P. DAVIS AND EDITH U. DAVIS

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INDEX

Question Presented 1

Statement 2

Statute Involved 3

Argument—

A Return of Capital Is Not "Income" Within the Sixteenth Amendment 3

Business Purpose and Absence of a Tax Avoidance Purpose 6

Attribution Rules: The Congressional Intent 13

No Decision in Conflict with Decisions Below 20

Conclusion 22

Table of Cases

Ballenger v. *United States*, 301 F. 2d 192 (C.A. 4) 20

Bedford's Estate v. *Commissioner*, 144 F. 2d 272 (C.A. 2) 8, 9

Bradbury v. *Commissioner of Internal Revenue*, 298 F. 2d 111 (C.A. 1) 19, 20

Cobb v. *Callan Court Company*, 274 F. 2d 532 (C.A. 5) 6

Colvin v. *United States*, 175 F. Supp. 877 (S.D. Calif.) 6

Commissioner v. *Berenbaum*, 369 F. 2d 337 (C.A. 10) 20

Commissioner v. *Estate of Bedford*, 325 U.S. 283 8

Commissioner of Internal Revenue v. *Snite*, 177 F. 2d 819 (C.A. 7) 8

Doyle v. *Mitchell Brothers Co.*, 247 U.S. 179 4

Eisner v. *Macomber*, 252 U.S. 183 ..... 3, 4

Estate of Henry A. Golwynne, 26 T.C. 1209 6

Herbert C. Parker, T.C. Memo. 1961-176, 20 T.C.M. 893 18

In Re Lukens' Estate, 246 F. 2d 403 (C.A. 3) 19
Joe L. Smith, Jr., et ux. v. *Commissioner*, 49 T.C. 476 6
J. Milton Sorem, 40 T.C. 206 (reversed 334 F. 2d 275 (C.A. 10)) 12
Keefe v. *Cote*, 213 F. 2d 651 (C.A. 1) 6, 9, 21
Kirschenbaum v. *Commissioner*, 155 F. 2d 23 (C.A. 2) .. 8
Leon R. Meyer, 46 T.C. 65 19
Levin v. *Commissioner of Internal Revenue*, 385 F. 2d 521 (C.A. 2) 9 18, 20
Oscar E. Baan, 51 T.C. 1032 12
Ragland Investment Co., 52 T.C. No. 92 5
Robert H. Herzog, T.C. Memo, 1963-303, 22 T.C.M. 1595 6

CONSTITUTIONAL PROVISIONS, STATUTES AND REGULATIONS

Constitution of the United States—

Article I, Section 2, Clause 3 ..... 4, 5
Article I, Section 9, Clause 4 ..... 4, 5
Sixteenth Amendment 3

Internal Revenue Code of 1954—

Section 301(b)(1) 19
Section 302 .....3, 14
Section 302(b)(1) 7, 9, 10, 13, 14, 16, 17, 19, 20
Section 302(b)(2) 15, 16
Section 302(b)(3) 15, 16
Section 302(b)(5) 15
Section 302(c) 15
Section 302(c)(1) 13
Section 306 .....12, 13
Section 311 14
Section 318 .....5, 14

Section 318(a) 13, 18
Section 318(a)(1)(A)(i) 19
Section 356(a)(2) 8

Internal Revenue Code of 1939—

Section 112(c)(2) 8
Section 115(g) 9, 12
Section 115(g)(1) 7, 13, 14, 16, 19

Revenue Act of 1924—

Section 201(f) 7

Revenue Act of 1926—

Section 201(g) 7, 8
Section 203(d)(2) 8

Treasury Regulations—

Section 1.302-2(b) 18
Section 1.302-2(c) 18

OTHER AUTHORITIES

Bittker and Eustice, Federal Income Taxation of Corporations and Sharholders, 2d Edition 1966, 291 7

Guide to the Internal Revenue Code of 1954, 1 U. S. Code Cong. & Adm. News, 84th Cong. (1st Sess. 1955), pp. 1183, 1274-5 14

House Ways and Means Committee Report (H. Rep. No. 1, 69th Cong., 1st Sess., p. 5) 9

H.R. 8300 "A Bill to Revise the Internal Revenue Laws of the United States"; House Report No. 1337, 3 U. S. Code Cong. & Adm. News, 83rd Cong. (2d Sess.) 1954, pp. 4025, 4060-1 14

New York University Thirteenth Annual Institute on Federal Taxation (1955), Redemptions: Dividend or Capital Gain; Death Taxes, Related Corporations, by Stephen T. Dean, pp. 547, 549-50 12

New York University Fourteenth Annual Institute on Federal Taxation (1956), Stock Redemptions: Sections 302 and 318, by George J. Laikin, pp. 671, 686 .. 12

Senate Finance Committee Report (S. Rep. No. 1622, 83rd Cong., 2d Sess., pp. 44-45), 3 U. S. Code Cong. & Adm. News, 83rd Cong. (2d Sess.) 1954, pp. 4675; 4870; 4623; 2684-6; 4793; 4867-4874 .....6, 7, 14

The Internal Revenue Code of 1954: Corporate Distributions, Organizations and Reorganizations, 68 Harvard Law Review 393, 398, 400 13

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REPLY BRIEF FOR MACLIN P. DAVIS AND EDITH U. DAVIS

QUESTION PRESENTED

Respondent* would rephrase the question presented as follows:

*As in petitioner's brief, Maclin P. Davis will be referred to as the respondent, since his wife is a party only because a joint income tax return was filed.

Whether the redemption by a corporation of preferred stock originally issued for cash in order to enable the corporation to obtain a loan, with the understanding that it would be redeemed when the loan was paid, was essentially equivalent to a dividend within Section 302(b)(1) of the Internal Revenue Code, solely by reason of (1) the existence of earnings and profits, and (2) the fact that after the preferred stock was purchased, the taxpayer purchased from another stockholder, and gave to two adult children, all the common stock not already owned by himself and his wife, and that he and his wife and children continued to own the common stock until the redemption of the preferred stock took place.

STATEMENT

Petitioner's statement in its brief follows the statement contained in the petition for certiorari in omitting the significant fact that the Tennessee Foundry & Machine Company had always intended to redeem the preferred stock when the RFC loan was paid off, and that the redemption was simply the final step taken in completion of the original purpose to provide working capital while the RFC loan was in effect, but no longer. (R. 9). It also omits to state, as did the petition itself, that the funds with which the preferred stock were redeemed were "surplus money"; that the corporation had the "cash in the bank" and was "paying 6% on it" [the preferred stock]; and that at the time Mr. Davis gave his discovery deposition more than three years later, the corporation had not "borrowed money from anybody." (R. 17-18).

STATUTE INVOLVED

Internal Revenue Code of 1954:

Sec. 302. Distributions in Redemption of Stock.

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

ARGUMENT

A Return of Capital Is Not "Income" Within the Sixteenth Amendment.

If Section 302 of the Internal Revenue Code could be construed as levying an income tax on the proceeds of the redemption in this case, it would be unconstitutional. The Sixteenth Amendment provides:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Petitioner has cited the landmark case of *Eisner* v. *Macomber,* 252 U.S. 189. The following paragraph from the opinion (p. 206) is pertinent here:

> "In order, therefore, that the clauses cited from Article I of the Constitution[1] may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income,' as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

In considering what constituted "income," the Court in *Eisner* v. *Macomber* said (p. 206) that what was required was "only a clear definition of the term 'income,' as used in common speech, in order to determine its meaning in the Amendment; . . ." The Court then cited *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179, involving the Corporate Tax Act of August 5, 1909, levying an excise tax on corporations, measured by "net income." The Court there held that in computing net income from the conversion of timber into lumber, the taxpayer was entitled to deduct from gross receipts the valuation (on the day before the effective date of the Act) of the stumpage cut and so converted, saying (p. 185):

> ". . . In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

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1. Article I, Section 2, clause 3, providing that "direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers," and Article I, Section 9, clause 4, providing: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

That the redemption proceeds of the preferred stock in the instant case were not income "according to truth and substance," and "as used in common speech," cannot be doubted. Respondent got back from the corporation in exchange for his preferred stock exactly what he paid in for the preferred stock,—no more and no less. A simpler illustration of a return of capital could not be imagined. This proposition would, indeed, not be questioned by petitioner were it not for the attribution rules of Section 318 of the Internal Revenue Code. We shall, later on, attempt to show that Congress did not intend these rules to be applicable in a situation such as here presented; but if Congress did so intend, it has disregarded "truth and substance." The Code, so construed and applied, runs afoul of Article I, § 2, cl. 3 and § 9, cl. 4 of the Constitution, because the tax is a direct tax which has not been apportioned among the states according to population, and it is not saved by the Sixteenth Amendment because it is not upon "income."

There was, in the instant case, a clearly identifiable date as of which the preferred stock was to be redeemed—the date of payment in full of the RFC debt,—so that the preferred stock had some of the characteristics of subordinated debt.[2] In considering whether there was a return of capital or a distribution of earnings and profits, the entire transaction, and not merely the last prong of

2. Petitioner belittles this point in its brief (pp. 29-30). However, at least four Tax Court judges recently expressed the view that dividends on preferred stock should be deductible as interest where there was an agreement to redeem. *Ragland Investment Co.*, 52 T.C. No. 92, filed August 26, 1969. We make no such contention here, but merely suggest the analogy, in a case involving dividend equivalence, between subordinated debt and preferred stock, where there is an understanding or agreement for its redemption.

a two-pronged transaction must be considered.[3] Even if the respondent in this case had actually owned all the common stock of the corporation from the beginning, the redemption of the preferred stock would have been a simple return of capital, not taxable as income under the Constitution.

Business Purpose and Absence of a Tax Avoidance Purpose

Petitioner's argument is that respondent constructively owned all the stock of the corporation, and that the redemption of any part of the stock of a sole owner is essentially equivalent to distribution of a taxable dividend to the extent of the corporation's earnings and profits, irrespective of business purpose and of absence of a tax avoidance purpose. In support of this theory petitioner (p. 18), quotes two sentences (relating to Section 302(b)(1) of the new 1954 Internal Revenue Code) from the Senate Finance Committee Report (S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 44-45)[4] as follows:

> ". . . While the House bill set forth definite conditions under which stock may be redeemed at capital-gain rates, these rules appeared unnecessarily restrictive, particularly, in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place.[5] Accordingly, your committee follows existing law by reinserting the gen-

3. *Keefe* v. *Cote*, 213 F. 2d 651 (C.A. 1); *Cobb* v. *Callan Court Company*, 274 F. 2d 532 (C.A. 5); *Colvin* v. *United States*, 175 F. Supp. 877 (S.D. Calif.); *Estate of Henry A. Golwynne*, 26 T.C. 1209; *Joe L. Smith, Jr., et ux.* v. *Commissioner*, 49 T.C. 476; *Robert H. Herzog*, T.C. Memo. 1963-303, 22 T.C.M. 1595.

4. 3 U. S. Code Cong. & Adm. News, 83rd Cong. (2d Sess.) 1954, p. 4675.

5. In this case Davis, the holder of the preferred stock, owned only one-fourth of the common stock,—the attribution rules aside.

eral language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend. . . ."

From the word "particularly," and the clause immediately following, petitioner draws the conclusion that the Senate Committee intended Section 302(b)(1) to have a "narrow application." Petitioner cites in a footnote (Footnote 15, p. 18) Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 2d Edition 1966, 291, to the effect that (based on the same word and clause) the provision's "major function was the narrow one of immunizing redemptions of minority holdings of preferred stock." It is difficult to follow this argument in view of the very next sentence in the Committee Report and of the lengthy explanation found in "Detailed Discussion of the Technical Provisions of the Bill,"[6] hereinafter referred to, which make it plain that Section 302(b)(1) was intended to follow "existing law" as developed under Section 115(g)(1) of the Internal Revenue Code of 1939 and its predecessor provisions. In the Detailed Explanation nothing further is said about redemptions of minority holdings of preferred stock, as we shall see.

The petitioner, in its brief (pp. 20-21) cites the legislative history of Section 201(g) of the Revenue Act of 1926 (the predecessor of Section 115(g)(1)), and argues that the courts between 1926 and 1954 disregarded this legislative history. But all that the Committee Reports were there attempting to explain was the inclusion in Section 201(g) of the parenthetical phrase "(whether or not such stock was issued as a stock dividend)." Under Section 201(f) of the 1924 Act (the corresponding provision), redemptions had not been treated as dividend distributions

6. 3 U. S. Code Cong. & Adm. News, 83 Cong. (2d Sess.) 1954, p. 4870.

unless they took place before or after the distribution of a stock dividend. The 1926 amendment made no change, however, in the former language that the redemption was taxable only if "essentially equivalent to the distribution of a taxable dividend," and only "to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913."

In arguing that business purpose and absence of a tax avoidance purpose were irrelevant under Section 201(g), as amended in 1926, petitioner apparently takes the position that Congress intended to impose an automatic dividend such as was imposed in Section 203(d)(2), relating to "boot" in reorganization exchanges. The contrast in language, however, is striking. In Section 203(d)(2) the phrase used was "has the effect of the distribution of a taxable dividend."[7] Moreover, the distribution was not required to "represent" a distribution of earnings and profits. The mere existence of earnings and profits was enough, and dividend treatment was automatic, provided there was "gain." It was so held in *Commissioner* v. *Estate of Bedford*, 325 U.S. 283. The failure to recognize the differences between these two sections may have given birth to the so-called "strict net effect" rule in connection with redemptions.[8]

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7. Section 203(d)(2) of the 1926 Act became Section 112(c)(2) of the 1939 Code and Section 356(a)(2) of the 1954 Code. It is clear that two essentially non-equivalent acts may have the identical "effect."

8. In *Commissioner of Internal Revenue* v. *Snite*, 177 F. 2d 819 (C.A. 7), the Commissioner relied upon *Estate of Bedford* in a redemption case, citing *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23 (C.A. 2), where the Second Circuit construed *Estate of Bedford* as overruling an earlier Second Circuit doctrine that "redemption of shares can never be 'essentially equivalent' to the payment of a dividend if the shares were originally issued for a bona fide corporate purpose." This Court in *Estate of Bedford* had reversed *Bedford's Estate* v. *Commissioner*, 144 F. 2d 272 (C.A. 2). As correctly held in *Snite*, while the Second Circuit's former interpretation was in error, *Estate of Bedford* was in no wise controlling. The Second Circuit's earlier error had been with respect

The House Ways and Means Committee Report (H. Rep. No. 1, 69th Cong., 1st Sess., p. 5), referred to in petitioner's brief (pp. 20-21), indicated that the 1926 amendment had the narrow purpose of closing a tax avoidance loophole under which stockholders could withdraw earnings and profits by the device of a pro rata sale to the corporation of part of their stock for redemption. We are not concerned in the instant case with business purpose in connection with a pro rata redemption of common stock, or of preferred stock originally issued in the tax-free incorporation of a business, or in exchange for common stock in a recapitalization. We are concerned with preferred stock originally issued for cash; and there is nothing in the Report to suggest that the redemption of such preferred stock was to be treated as the payment of a dividend merely because it is pro rata. Of course, redemptions of preferred stock originally issued as a stock dividend were covered both before and after the 1926 amendment.

After arguing that the "numerous decisions"[9] under Section 115(g) of the 1939 Code and its predecessor provisions were "wrongly decided," on the ground that they ignored the legislative history of the 1926 Act (Brief, p. 20), the petitioner next argues that Section 302(b)(1) of the 1954 Code changed "existing law"[10] because it omitted the phrase "at such time and in such manner" contained in Section 115(g). (Brief, pp. 21-22). But when we look

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to redemptions of shares originally issued as stock dividends to capitalize accumulated earnings and profits; and the Court overreacted to this Court's reversal of its decision in *Bedford's Estate*. See *Levin* v. *Commissioner of Internal Revenue*, 385 F. 2d 521, 523-4 (C.A. 2), in which the Court adheres to its erroneous view that *Estate of Bedford* overruled its earlier cases.

9. The most recent of these cases prior to the enactment of the 1954 Code was *Keefe* v. *Cote*, 213 F. 2d 651 (C.A. 1), decided June 18, 1954.

10. As to petitioner's argument on corporate contraction (p. 22, footnote 19), see our footnote 11, infra, p. 12.

at the legislative history of Section 302(b)(1), there is nothing in any committee report to suggest that the phrase "at such time and in such manner" was omitted for any reason other than the obvious reason that it was superfluous and redundant. The Senate Committee's language was to the effect that in reverting to the "essentially equivalent" test, it was not changing but (at least "in general") was incorporating "existing law." The abbreviation of the language used was of no significance. In its "Detailed Discussion of the Technical Provisions of the Bill," the Committee said:

> "Section 302 corresponds in function to section 302 of the House bill and relates to section 115(c), (g), and (i) of the 1939 Code. Under this section, rules are prescribed for the tax treatment to shareholders receiving distributions of property in redemption of stock. As under section 302 of the House bill, distributions in redemption of stock which qualify as distributions in complete or partial liquidations under part II of subchapter C are not within the scope of section 302. Unlike the House bill, however, section 302 does not provide specific statutory guides governing the tax consequences of every stock redemption. In lieu of the approach in the House bill, your committee intends to revert in part to existing law by making the determination of whether a redemption is taxable as a sale at capital gains rates or as a dividend at ordinary income rates dependent, except where it is specifically provided otherwise, upon a factual inquiry. For special rules relating to the redemption of section 306 stock, see the discussion under section 306."

And again:

> "Subsection (b) of section 302 states three conditions in paragraphs (1), (2), (3), and (4), the satisfaction of any one of which will result in the treat-

ment of the redemption as a distribution in full or part payment in exchange for the stock. In general, under this subsection your committee intends to incorporate into the bill existing law as to whether or not a reduction [sic] is essentially equivalent to a dividend under section 115(g) (1) of the 1939 Code, and in addition to provide three definite standards in order to provide certainty in specific instances."

And again:

"The test intended to be incorporated in the interpretation of paragraph (1) is in general that currently employed under section 115(g) (1) of the 1939 Code. Your committee further intends that in applying this test for the future that the inquiry will be devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation. For this purpose the presence or absence of earnings and profits of the corporation is not material. Example: X, the sole shareholder of a corporation having no earnings or profits causes the corporation to redeem half of its stock. Paragraph (1) does not apply to such redemption notwithstanding the absence of earnings and profits. The fact that the proceeds of the redemption are not taxable as ordinary income to X results through application of section 302(d) and section 301."

Petitioner stresses (p. 19) the second sentence in the last paragraph above quoted. Petitioner asserts that a sale results in a reduction of the shareholder's proportionate interest, while a dividend does not; points out that a sale to the corporation of stock for redemption by a *sole* stockholder cannot reduce such sole stockholder's proportionate interest; and draws the conclusion that what appears to be a sale by a sole stockholder cannot, therefore, be a sale, but only a redemption essentially equiva-

lent to a dividend, because of the original hypothesis that a sale must reduce the stockholder's proportionate interest. This is the well-known fallacy of the ambiguous middle. A "sale" to a third person and a "sale" to the corporation are two different things.

It has been previously noted that the Senate Committee Report expresses the intention that existing law be followed "in general." One plausible explanation for this phrase is that corporate contraction may be no longer a criterion as it was under the 1939 Code.[11] In addition, the statement that "presence or absence of earnings and profits is not material" was apparently a complete rejection of the "net effect" criterion where business purpose and absence of tax avoidance purpose are found, as in the instant case.[12]

Petitioner argues, however (pp. 24-25), that Section 306 of the 1954 Code, relating to preferred stock "bail outs," specifically excepted from its provisions a disposition of preferred stock when it "was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax." The petitioner's argument is that this specific exception in Section 306 implied an in-

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11. See *J. Milton Sorem*, 40 T.C. 206, 218-219 (reversed 334 F. 2d 275 (C.A. 10)) where Judge Dawson, in a dissenting opinion, explains that "corporate contraction, as a measure of dividend equivalency, is now pertinent only to section 346, and has no meaning with regard to section 302." See also *Oscar E. Baan*, 51 T.C. 1032, where the Court, under the caption "II. Applicability of Section 346," remarks: "Further, the test of section 346(b)—the cessation of an active business—was *prior to the 1954 Code* a major judicial test for determining whether a distribution was 'essentially equivalent to a dividend' under section 115(g) of the 1939 Code." (Emphasis supplied).

12. New York University Institute on Federal Taxation, Thirteenth Annual (1955), pp. 547, 549-50 (Stephen T. Dean on Stock Redemptions); ibid., Fourteenth Annual (1956), pp. 671, 686 (George J. Laikin on Stock Redemptions).

tention that absence of a tax avoidance purpose was to be irrelevant under Section 302(b)(1). But Section 306 was new, while Section 302(b)(1), as we have seen, was intended to incorporate "existing law," so that it was unnecessary for Congress to spell out what "existing law" embodied. It is undisputed that business purpose and absence of a tax avoidance purpose were considered by most courts in applying Section 115(g)(1) of the 1939 Code and predecessor provisions; and this was known to the Treasury and the Senate Committee. Petitioner merely argues that these decisions were wrong.

Attribution Rules: The Congressional Intent

Section 302(c)(1) of the 1954 Code provides that, with exceptions not here material, "section 318(a) shall apply in determining the ownership of stock for purposes of this section." Section 302(b)(1) is a part of "this section," and for that reason the petitioner argues that respondent was the constructive owner of the common stock of his wife and two adult children, and for purposes of this case the sole owner of the stock of Tennessee Foundry & Machine Company. We believe that petitioner gives too much meaning to the words "for purposes of this section" and that what Congress intended was that Section 318(a) should apply for the purposes of those provisions of the section where ownership of stock is mentioned, viz., paragraph (2) of subsection (b) relating to substantially disproportionate redemptions, and paragraph (3) of subsection (b) relating to termination of a shareholder's interest.[13] We think that the legislative history demonstrates

13. See The Internal Revenue Code of 1954: Corporate Distributions, Organizations and Reorganizations, 68 Harvard Law Review 393, by Edwin S. Cohen and others, footnote 38, p. 398, and footnote 51, p. 400; cf. Guide to the Internal Revenue Code of 1954, 1 U. S. Code Cong. & Adm. News, 84th Cong. (1st Sess. 1955), pp. 1183, 1274-5, where there is no mention of the attribution rules in connection with Section 302(b)(1).

that such was the intention, especially when the sequence of events is considered by which the "essentially equivalent" test became belatedly incorporated into the bill which was finally enacted into law.

As the bill came from the House to the Senate, the attribution rules were in Section 311 rather than 318, and Section 302 did not include the "essentially equivalent" test.[14] It did include, in substance, the provisions which became paragraphs (2) and (3) of subsection (b), with the provision that Section 311 should be "applicable in determining the ownership of stock." The mechanical tests based on ownership and the attribution rules were wrapped up in a single package, which did not include the old "essentially equivalent" test. But the Senate Committee thought the House bill unnecessarily restrictive and added, in substance, old Section 115(g)(1), while retaining the provision relating to the attribution rules exactly where it was found. It is reasonable to assume, therefore, that the Senate Committee intended for the attribution rules to be applicable only where they would have been applicable if the House bill had been adopted without the addition of the "essentially equivalent" test.

This conclusion is fortified by the fact that nowhere in the Senate Committee Report,—either the preliminary portion[15] or the Detailed Explanation,[16]—was there any mention whatever of attribution rules in connection with the "essentially equivalent" test of Section 302(b)(1). Although it was stated several times that the Committee

14. H.R. 8300 "A Bill to Revise the Internal Revenue Laws of the United States"; House Report No. 1337, 3 U. S. Code Cong. & Adm. News, 83d Cong. (2d Sess.) 1954, pp. 4025, 4060-1.

15. 3 U. S. Code Cong. & Adm. News, 83d Cong. (2d Sess.) 1954, pp. 4623, 4684-6.

16. Ibid. pp. 4793, 4867-4874.

intended to revert to "existing law," there was no qualification of this statement by reference to the attribution rules. On the other hand, in the explanation of paragraph (2) of subsection (b), (the substantially disproportionate test), it is said: "In determining the ownership of stock, subsection (c) makes clear that the rules of constructive ownership provided in section 318 are applicable." And in the explanation of paragraph (3), (the termination of interest test), it is said: "This paragraph must be read in connection with the provisions of subsection (c) of section 302 relating to constructive ownership of stock."[17]

In determining the intention of Congress, it is significant that paragragh (5) of Section 302(b) of the Code, as finally enacted, states that failure "to meet the requirements of paragraph (2), (3) or (4) shall not be taken into account" in determining whether the requirements of paragraph (1) are met. Let us suppose a case where the failure to meet the requirements of paragraph (2) or (3) is solely because of the attribution rules. In such a case, if the attribution rules are also "taken into account" with respect to paragraph (1), it is clear that the mandate of paragraph (5) has been disobeyed. This demonstrates that Congress did not intend for the attribution rules to be "taken into account" in determining whether the requirements of paragraph (1) are met.

The argument is clinched, we submit, by the following sentence in the preliminary Senate Report, following the brief discussion of the substantially disproportionate

17. Petitioner emphasizes (p. 34) the statement in the Senate Committee report that Section 302(c) "provides rules for determination of the constructive ownership of stock *for the purpose of Section 302.*" But the phrase "for the purpose of Section 302" provides no further clue to what was intended than the phrase "for the purposes of this section" in the Act itself, from which the general statement in the report is adopted.

test and the termination of interest test. The Committee said: "However, *in order to prevent tax avoidance*, your committee follows the rules of the House bill whereby, *under specific circumstances*, a shareholder may be considered as owning stock held by members of his family (or by partnerships, corporations, or estates trusts in which he has an interest)." (Emphasis supplied). It is highly significant that the attribution rules were retained "for purposes of preventing tax avoidance" and for no other expressed purpose, and further, that the "specific instances" in which the attribution rules were to apply excluded instances embodied in present Section 302(b)(1) for the very simple reason that there was no provision in the House bill analogous to Section 302(b)(1).

Since Congress intended to perpetuate, at least "in general," the "existing law," we submit that Congress would have been most explicit if it had really intended to graft onto this existing law the fiction of constructive ownership of stock."[18] In establishing the formal or "safe harbor" tests of paragraphs (2) and (3) of Section 302(b), based on ownership of stock, it was appropriate to retain the attribution rules of the House bill to prevent tax avoidance. Paragraph (1), however, merely perpetuates the principle of substance over form of Section 115(g)(1) of the 1939 Code. A question of substance over form should always be decided by factual inquiry on the basis of reality rather than fiction. Indeed, the Senate Committee's Detailed Explanation expressly states that the determination of dividend equivalence under Section

18. Petitioner makes no contention that by the use of the words "in general" the Senate Committee was trying to say that the attribution rules applied in determining dividend equivalence. Such a contention would lack plausibility in view of the specific references to the attribution rules in the explanations of paragraphs (2) and (3) of subsection (b) and the total absence of any such reference in the explanation of paragraph (1).

302(b) is to be "dependent, except when it is specifically provided otherwise, upon a factual inquiry."[19] Paragraph (1) of Section 302(b) does *not* "specifically provide otherwise."

An ambiguous statutory provision should be construed to accomplish a rational rather than an incongruous result and to avoid constitutional doubts. The existing law to which Congress intended to revert when it added Section 302(b)(1) to the "safe harbor" tests adapted from the House bill (which were packaged with the attribution rules) was realistic rather than formal. To hitch the arbitrary attribution rules to the earlier test of realism brings about a more incongruous result than the centaur of ancient mythology—a man's head and torso on a horse's body, —as the instant case well illustrates.

Let us suppose that Tennessee Foundry & Machine Company had no current earnings but had accumulated earnings and profits of exactly $25,000 when the preferred stock was redeemed, and that after the redemption, the corporation paid a dividend of $25,000 to the common stockholders. If the petitioner's position is correct, the common stockholders would receive no taxable income (since earnings and profits had been exhausted), while the respondent would have been subjected to double taxation—first, on the income from which the original $25,000 was derived, with which the preferred stock was purchased, and, second, on the $25,000 received when the preferred stock was redeemed.

If this incongruous result does not shock the Court where taxpayer's wife and children are the beneficiaries (along with the Treasury, of course), it must be remem-

19. 3 U. S. Code Cong. & Adm. News, 83d Cong. (2d Sess.) 1954, p. 4870.

bered that the attribution rules also apply as between partnership and partners. Suppose that a partnership with numerous partners owns the preferred stock and a single partner owns all the common stock. Here the one partner owning the common stock would benefit at the expense of all the other partners. Moreover, the Treasury, by regulation, has sought to give this one partner (in the assumed illustration) an additional benefit. It has provided that the basis of the redeemed preferred stock shall be added to the basis of the common stock owned and retained by the person whose ownership has been attributed to the taxpayer.[20] There is no statutory authority for this regulation, which perhaps demonstrates the Treasury's recognition of the inequity of the provision in its regulation that "one of the facts to be considered" in deciding dividend equivalence is constructive ownership under Section 318(a). We insist that this portion of Treas. Reg. § 1.302-2(b) is invalid, for all the reasons heretofore stated.

The lower courts have followed the Treasury regulation, but with one qualification: in the case of family estrangement. *Herbert C. Parker*, T.C. Memo. 1961-176, 20 T.C.M. 893. In *Levin* v. *Commissioner*, 385 F. 2d 521 (C.A. 2), the Court said in this connection (p. 527):

> "We do not hold that there may not be cases in which strict application of the attribution rules may be inappropriate. In addition to the preferred stock situations referred to in the Senate Report quoted supra [redemptions where the shareholder has no control over when the redemption may take place], family estrangement may render the application of the family attribution rules unwise. . . ."

In a recent case the Tax Court, in applying the attribution rules, said that the evidence showed "an almost touch-

20. Treas. Reg. Section 1.302-2(c) cited by petitioner in Footnote 12, p. 15.

ing picture of family affection, trust and cooperation." *Leon R. Meyer*, 46 T.C. 65, 89. To the same effect, see *Bradbury* v. *Commissioner of Internal Revenue*, 298 F. 2d 111, 116-7 (C.A. 1). As previously pointed out, the attribution rules also apply between partnership and partner, and likewise between beneficiary and trustee. How can the tax practitioner, the revenue agent, and ultimately the Court, decide just what degree of estrangement will prevent application of the attribution rules to Section 301 (b)(1) under the varying circumstances which may arise among these groups of related persons?

The answer is, of course, that there can be no judge-made exceptions to statutory rules. Either a statutory rule is applicable or it is not applicable. There is no question about applicability of the attribution rules to paragraphs (2) and (3) of subsection (b), with the statutory exception of Section 318(a)(1)(A)(i),—a spouse "who is legally separated from the individual with a decree of divorce or separate maintenance." To say that judge-made exceptions are allowable with respect to paragraph (1) is really to say that the rules do not apply to paragraph (1).

If we are correct in our insistence that the attribution rules do not apply to Section 302(b)(1), we must go back to "existing law" under Section 115(g)(1) of the 1939 Code, where the question of family relationships arose in a few decided cases. It is clear that ownership of stock by adult children, with separate families and homes of their own, would not have been attributed to the parent.[21]

21. See *In re Lukens' Estate*, 246 F. 2d 403 (C.A. 3), and cases cited, p. 407.

No Decision in Conflict with Decisions Below

While the lower courts have followed the Treasury regulation in holding the attribution rules applicable to Section 302(b)(1), there is no decided case in which a redemption of either preferred or common stock has been held to be essentially equivalent to the distribution of a taxable dividend solely by virtue of these rules, where a genuine business purpose was found to exist. Petitioner has cited (p. 35) *Ballenger* v. *United States*, 301 F. 2d 192 (C.A. 4), and *Commissioner* v. *Berenbaum*, 369 F. 2d 337 (C.A. 10), but in both cases the distribution was substantially pro rata without applying the attribution rules. In *Ballenger* the taxpayer husband owned all the common stock except one share in the name of his wife, which the Court said was "too small to upset the pro rata characterization of the distribution." (301 F. 2d 199). With respect to the taxpayer in *Berenbaum*, "there was no reduction in his control, and only an insignificant reduction in ownership represented by the redeemed shares." (369 F. 2d 341).

In *Ballenger*, moreover, the Court expressly held that there was "no legitimate business purpose" for the redemption (301 F. 2d 199); and in *Berenbaum* the Court emphasized the failure of the taxpayer to "come forward with additional evidence on the question" [of business purpose] after the basic facts had been stipulated and the issue had been placed in controversy by the pleadings. (369 F. 2d 341). In *Bradbury*, *supra*, cited by petitioner (Brief, p. 35), the stockholder had borrowed money from the corporation for personal use and then turned in stock for redemption in order to pay the debt and clean up the corporation's balance sheet. In *Levin*, *supra*, also cited, there was no contention of business purpose. In short,

there is no decided case in conflict with the decision in the instant case.

Petitioner does not controvert the finding that there was no tax avoidance purpose, but contends (pp. 25-32) that there was no business purpose in the redemption, basing this contention largely on the remark of the Court in *Ballenger, supra,* that "we cannot understand how a valid reason for the issuance of preferred stock can, once its purposes have been served, be converted into a reason for its redemption." The Fourth Circuit's difficulty in that respect was perhaps due to its mode of expression. There is, of course, no *converting* of a reason for the issuance of preferred stock into a reason for its redemption; but if preferred stock is issued for a temporary purpose, and is redeemed when that purpose has been served, the redemption cannot fairly be viewed in complete isolation.[22]

Petitioner argues (Footnote 21, pp. 26-27) that in *Keefe* v. *Cote,* 213 F. 2d 651 (C.A. 1), and in the Tax Court cases relying on it, there was a factor not present here, viz., that the preferred stock had in each case been issued for debts owing the taxpayer for compensation, which had been reported for income taxation, so that to tax the redemption proceeds would amount to double taxation. As petitioner correctly points out, however, the taxpayers were in no different position than if they had received cash for their services and thereafter acquired preferred stock. What petitioner overlooks is that double taxation would result just the same,—and that in the instant case, double taxation would also result. Respondent did not buy the preferred stock with money picked off a tree.

22. See cases cited in footnote 3, *supra,* p. 6.

Finally, any normal corporate board of directors in 1963, with surplus funds on deposit in a bank, and no anticipated need for them in the corporate business, would have redeemed outstanding 6% preferred stock at par, even in the absence of an understanding or agreement to do so. Petitioner says (p. 31, footnote 25) that this is not a business purpose because the corporation can convert preferred stock into common stock. But this preferred stock was not convertible into common stock at the option of the corporation, or even at the option of the holder. Petitioner further says that the same result could be achieved "by a simple surrender of the preferred shares without any cash distribution." But perhaps respondent needed the money, and did not feel impelled to make an indirect gift to his wife and adult children of $25,000, after having given them most of the common stock.

CONCLUSION

The judgment of the Court of Appeals affirming the judgment of the District Court should be affirmed by this Court.

Respectfully submitted,

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